National Association of Private Fund Managers

301 Commerce Street, Suite 2600
Fort Worth, Texas, 76102

May 27, 2022

Ms. Vanessa A. Countryman Secretary
U.S. Securities and Exchange Commission
100 F. Street NE
Washington, DC 20549-1090

Via email to rule-comments@sec.gov

Re: File Number S7-12-22; Release No. 34-94524
Comments on Proposed Rule for Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer

Dear Ms. Countryman:

The National Association of Private Fund Managers (the "Association") submits this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comment upon the proposed rules to further define the phrase "as part of a regular business" under the definition of "dealer" and "government securities dealer" in the Securities Exchange Act of 1934 ("Exchange Act"), published in Release 34-95424, File No. S7-12-22 on March 22, 2022 (the "Proposal").

The Association, a non-profit organization whose members are investment advisers in the private fund management industry,[1] believes that the Proposal suffers from multiple deficiencies including a lack of statutory authority, inherent conflicts with the framework designed by Congress as contained in the securities laws, inadequate evaluation of industry factors and costs related to private funds, advisers and managers, and an overly broad application without adequate evaluation of the harm and alternatives to achieving the desired benefit. In its current form, the Proposal would require many private funds (or their investment adviser fund managers (referred to herein as either "advisers" or "managers")) to register as a "dealer" or "government securities dealer." The Commission acknowledges the impact upon private funds but then disregards it without an appropriate analysis. We appreciate the opportunity to provide comments on the Proposal and on these significant deficiencies that necessitate a withdrawal and reconsideration of the Proposal.

We are aware of comment letters submitted or being prepared for submission, by other entities and individuals raising concerns about the Proposal and recommending that it not be adopted or that the Commission undertake further study to significantly revise the Proposal. The Association concurs with concerns expressed by the Managed Funds Association, the Asset Management Group of the Securities Industry and Financial Markets Association, and the Alternative Investment Management Association, and agrees that the Proposal is not in the public interest, is arbitrary and capricious, and lacks both evidentiary and statutory foundation for

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[1] The Association, domiciled in Texas, was founded for, among other things, providing education to its members and representing the legal and economic interests of private fund and private equity managers before the government and in the courts.

adoption. We will not repeat here all of the legal analysis and arguments which are well-articulated by those notable and well-regarded commentators. Instead have summarized the points which the Commission should consider and address before drafting any final rule. Based on the comments, we request that the Commission withdraw the current Proposal and engage in thoughtful reconsideration before adopting rules so significantly impacting the private fund industry (including its institutional investors and their underlying constituents). Alternatively, should the Commission determine to proceed with the Proposal, we request that the Commission create an exclusion for private funds and their investment adviser managers.

Our summary of the primary concerns are as follows:

1. **The Proposal Exceeds the Commission's Statutory Authority**. Section 3(a) of the Exchange Act defines "broker" and "dealer" in parallel terms. A broker is "any person engaged in the business of effecting transactions in securities for the account of others," whereas a "dealer" isas "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." At the time the Exchange Act was enacted, the concepts of trading for one's "own account" or for the "account of others" was commonly used to distinguish, in functional terms, how a public securities business effectuated a customer's order. A broker would effectuate a customer order by buying or selling for the customer as an agent (through the "customer's account"), whereas a dealer would effectuate a customer order by taking the opposite side in his "own account"—buying from, or selling to, the customer as a principal. Congress established the Exchange Act with provisions addressing this conduct of brokers and dealers and separately legislated the Investment Advisers Act of 1940 ("Advisers Act") to govern the entirely different conduct of investment advisers. By rulemaking, the Commission now is attempting to expand the definition of a dealer beyond that contemplated in the securities laws, conflate and confuse the differing roles of dealers and advisers, and undermine the separate regulatory structures established by Congress. In Section 3(b) of the Exchange Act the Commission is given authority to further define the terms set forth in the Act but it is limited to rulemaking that is consistent with the Congressionally specified "provisions and purposes." Notably, the Commission's prior attempt to capture banking entities within the definitions of broker and dealer was successfully challenged as an overreach of authority.[2] The Proposal, which brings a large number of advisers and private funds into the scope of the Exchange Act and calls them "dealers," similarly disregards the statutory construct and contravenes Congressional intent.

2. The Proposal and its application are overly broad. Section 3(a)(5)(B) of the Exchange Act excludes from the definition of a dealer, "a person that buys or sells securities . . . for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." Private funds, advisers and others have traditionally been excluded from the

[2] *Am. Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986). The Court in *Am. Bankers Ass'n* addressed the Commission's attempt to extend the definition of broker and dealer to include bank entities governed by other regulations and agencies. This decision is instructive here. Congress purposefully divided the regulatory structure between advisers on the one hand governed by the Advisers Act and brokers and dealers on the other governed by the Exchange Act.

definition of dealer and, under that provision, have been referred to as "traders" in Commission statements and publications as well as industry guidance and treatises.[3]

The Proposal would throw that model into disarray and, through the use of vague, broad, and undefined terms, capture many advisers and private funds within the definition.[4] The Proposal sets forth two new rules, Rule 3a5-4 and Rule 3a44-2, to further define the terms dealer and government securities dealers to identify certain activities that would constitute a "regular business" and thus require any person engaged in those activities to register.

Focusing here on the term "dealer," the newly devised determinants of which firms fall into that category create significant ambiguity and overreach concerning when funds and advisers will be required to register. In short, the Commission's definitional error is as basic as this: The Commission reasons that because dealers provide liquidity, and large traders do too, large traders are dealers. This is known as the fallacy of the undistributed middle. In layman's terms, cats have four legs, and dogs do too, but that does not mean dogs are cats. Indeed, by the SEC's reasoning, all purchase transactions provide liquidity to the seller, so all purchasers must be dealers, too.

Because of the problems with the terms and factors used to further define a dealer, many private fund managers and private funds themselves, who are already subject to registration and ample regulation requirements, are needlessly captured by the Proposal and would be required to registered and additionally report as a dealer. Each of the Proposal's newly established terms and requirements creates uncertainty concerning when funds and advisers may be caught within the definition of a dealer. The problematic and overly broad phrases include, among others:

- "For its own account" has been defined in the Proposal to include not just the account of a firm or entity but also to aggregate a firm's account with, among others, discretionary accounts in the name of clients, private funds' accounts, and pooled assets or other "parallel account structures." This fails to consider, among other things noted in the comment letters, that private funds and their managers trade securities through registered broker-dealers and their activities are thereby subject to that broker-dealer's reporting and transparency obligations. Additionally, the Proposal fails to provide justification for requiring private funds and fund managers to aggregate their trading and positions with accounts that may be managed by others within the same parent entity, such as portfolio managers acting independently and without coordination, or with discretionary client accounts.

- "Routinely" is used in the Proposal as a component of the qualitative factors under which a person or entity will be deemed to be a dealer. "Routinely" is defined therein to mean "more frequent than occasional but not necessarily continuous," such that a person's

[3] *See, e.g.*, Testimony of Arthur Levitt, Chairman, SEC, Concerning Hedge Fund Activities in the US Financial Markets, Before the House Committee on Banking, Finance and Urban Affairs (Apr. 13, 1994) and Testimony of Richard R. Lindsey, Dir., Div. of Mkt. Regulation, SEC, Concerning Hedge Fund Activities in the US Financial Markets, Before the House Committee on Banking and Financial Services (Oct. 1, 1998).

[4] The Commission is clear on this impact stating: "the Proposed Rules would primarily require registration by PTFs, and potentially some private funds. In addition, it is possible that the activities of some investment advisers could meet the Proposed Rules and trigger a dealer registration requirement."

transactions in roughly comparable positions, throughout the day and routinely over time, constitute "[engaging] in a routine pattern of buying and selling securities that has the effect of providing liquidity for market participants." This amorphous definition fails to provide guidance or parameters and leaves it to the firms and to the Commission's examination and enforcement divisions to determine. Indeed, using the word "routine" to define "routinely" is a prime example of a circular definition.

- "Roughly comparable purchases" and "sales of the same or substantially similar securities" are likewise ill-conceived and vague notions within the Proposal's qualitative analysis. The Commission has acknowledged that the phrases do not provide bright lines. The terms are likely to bring into the definition of dealer private funds and advisers who use options strategies or who are simply engaged in hedging along with other trading activity. The Association believes that these opaque standards create ambiguity and will subject unknowing private funds to second-guessing by the examination and enforcement staff of the Commission, and by plaintiffs' lawyers.

- Trading "that has the effect of providing liquidity to other market participants" for determining whether a firm is a broker is an impractical and illogical benchmark. The Commission proposes to entirely dismiss a party's intent in its trading activity. This standard would require private funds to constantly apply hindsight judgment on the collateral impact of its trading. As such it is an unworkable standard that disregards years of settled practice with no corresponding or compelling benefit. Further, (1) whether any given activity has a specified effect can only be determined after the fact, whereas whether a firm must register as a dealer must be determined in advance, so that the "effect" formulation is simply unworkable, and (2) every purchase transaction provides liquidity to the seller, so that the confines of the "providing liquidity" constraint are indeterminable.

- Trading more than "$25 billion of trading volume in government securities" as a stand-alone quantitative threshold for "government securities dealer" registration is unwarranted and overbroad. The Commission has offered interpretive guidance on dealer status for decades but has never before suggested that the volume of trading alone is sufficient to render a firm a dealer—and for good reason. As the Commission admits in the proposal, a "rule that relies solely on quantitative factors" is not a "reliable" way to identify "dealers." The Commission cannot rationally explain why any quantitative threshold is warranted, much less justify the arbitrary threshold proposed here.

None of these activities, alone or in aggregate make a private fund or its manager a dealer. Therefore, they should not be used to require dealer registration by private funds and advisers.

3. **The Commission's Proposal fails to reliably assess the costs and impact of the Proposal.** Under the Administrative Procedure Act ("APA"), the Commission's rulemaking may be determined unlawful if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[5] Proposed regulations and rules have been found to be arbitrary and

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[5] 5 U.S.C. § 706(2)(A).

capricious where the agency has not adequately assessed the entire economic impact of a proposed rule. Additionally, Section 3(f) and 23(a)(2) of the Exchange Act require the Commission to evaluate the impact accurately and comprehensively including, in addition to the protection of investors, whether the action will promote efficiency, market competition and capital formation. The APA further requires the Commission to provide detail and rationale around its rule-making, including "technical studies and data that it has employed in reaching the decision to propose particular rules."[6]

The Commission's analysis of the costs to the private fund industry is simply a "guestimate" expanding on prior limited research and proposals, such as Regulation Crowdfunding, without substantive studies and data to support the analysis. The Commission's analysis identifies (without meaningful substantiation) the per-firm cost of additional registration as a dealer with the Commission and an SRO ($600,000 initially and $265,000 annually thereafter) and consolidated audit trail ("CAT") reporting ($965,000 to $8,218,000 for one-time implementation, plus ongoing costs of $503,000 to $5,405,000 annually). The Association believes those estimates are understated very significantly. Moreover, the Proposal fails to consider additional collateral costs related to surveillance, monitoring and compliance systems as well as complying with unique dealer requirements such as the net capital rule. In the face of these increased costs, the Association and its members believe that market efficiency, competition and capital formation will suffer as participants withdraw from markets or segments of markets, an inevitable consequence of the rule. Those social costs are ignored completely in the release.

Funds, their investors, and ultimately the securities markets generally will be negatively impacted in multiple ways—reduced investment opportunities, reduced competition, greater concentration, and systemic risks. Less efficient price discovery, and increased costs of capital-raising are additional consequences. By being swept into the definition and required to register as a dealer, the Commission ironically and contrary to goal of investor protection will cause private funds to lose certain protections afforded to them as customers of a broker-dealer and may cause private fund investors to lose liquidity rights. The Commission needs further information on the potentially damaging consequences to the market arising from the Proposal. Repeated references to the "uncertain impact" upon each of these factors is insufficient to justify the costs and burdens to be imposed and an admission that the analysis is lacking.

Additionally, the Commission fails to properly evaluate the number of private funds and investment advisers that will be subject to the registration requirements if the Proposal is adopted in its current form. The private fund industry associations and members uniformly assert that the Commission's estimates are flawed and understated. The Commission is relying on what it admits is limited data (even though substantial additional data is readily available to the Commission) and has not sought to conduct studies on the number of firms impacted.

4. **Private funds and fund managers should be exempt from the Proposal.** Private fund managers and advisers are governed by the Advisers Act and are fiduciaries who must always act in the best interests of their clients. By contrast, true dealers act on their own behalf and for

[6] 5 U.S.C. § 553(b); *See*, *Kern Cty. Farm Bureau* v. *Allen*, 450 F 3d 1072, 1076 (9th Cir. 2006) (internal citation omitted).

their own interests. The rules applicable to advisers and fund managers as fiduciaries are largely principles-based while those applicable to dealers are prescriptive. The Commission proposes to exclude registered investment companies because “they report to the Commission on many aspects of their operations and their portfolio holdings” and they “must maintain certain books and records and make them available for examination by the Commission” which provides the Commission with “extensive oversight of registered investment companies and broad insight into their operations and activities.” Immediately after explaining that exclusion, the Commission arbitrarily determines that private funds and investment advisers should not be excluded. The Proposal evaluates the nearly identical reporting, books and records and examination requirements applicable to private funds and advisers, but in perfunctory manner then makes the illogical leap that they are insufficient by comparison. The Commission ignores the ways in which private funds plainly are better insulated from risk than registered investment companies, *for example*, daily versus monthly or quarterly redemption rights without significant prior notice. And the Proposal fails to address why additional limitations on leverage by private funds imposed by agencies other than the Commission are insufficient, including Federal Reserve Regulations T, U, and X, which are arguably more restrictive than dealer limitations, and Financial Industry Regulatory Authority Rule 4210 that imposes margin requirements on a fund borrowing from a broker-dealer.

The Commission should exclude private funds and their investment advisers from the definition of dealer consistent with the Proposal’s exclusion for investment companies. Private funds and investment advisers, like investment companies, are already subject to extensive regulation. It is illogical to subject those already regulated under one Act to be captured and required to comply with yet another Act to address this issue.

Conclusion. As discussed above and in the comment letters referenced previously opposing the Proposal, the Association believes that the Proposal lacks statutory authority, conflicts with the framework designed by Congress in the securities laws, contains a substantially inadequate evaluation of industry factors and costs as compared to the benefits the Proposal seeks to achieve, and includes arbitrary, overly broad, vague, and unworkable terms for application of the definition proposed. We would welcome the opportunity to continue discussing these issues and the Proposal generally. Please contact us at the above address should you wish to follow up on or meet with us regarding our concerns with the Proposal.

Sincerely,

National Association of Private Fund Managers

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets
Mr. William Birdthistle, Director, Division of Investment Management